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No. 94, Original

IN THE

Supreme Court of the United States

OCTOBER TERM, 1983

STATE OF SOUTH CAROLINA,

Plaintiff,

vs.

DONALD T. REGAN, Secretary of the Treasury of the United States of America,

Defendant.

MOTION FOR LEAVE TO FILE A BRIEF *AMICUS CURIAE* AND *AMICUS CURIAE* BRIEF

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In the

Supreme Court of the United States

October Term, 1983

No. 94, Original

State of South Carolina,

Plaintiff,

vs.

Donald T. Regan, Secretary of the Treasury of the United States of America,

Defendant.

Motion for Leave to File Brief *Amicus Curiae*

The City of Baltimore and the National Institute of Municipal Law Officers hereby respectfully move for leave to file the annexed brief *amicus curiae* in the above-captioned case.

Amicus City of Baltimore is a political subdivision of the State of Maryland. *Amicus* National Institute of Municipal Law Officers is the national organization of civil attorneys for cities in the United States and other political subdivisions of the States. The City of Baltimore and the other cities and political subdivisions whose attorneys are members of said *amicus* regularly issue bonds for their governmental purposes. The issue in this case is whether the United States may constitutionally tax the interest on such bonds if they are not registered. Briefs heretofore submitted in the case also raise the broader question whether the United States may constitutionally tax the interest on such bonds whether or not they are registered.

All political subdivisions have a vital interest in the answers to these questions because (1) the taxation of their unregistered bonds would effectively prevent them from issuing such bonds and thereby deprive them of the option to do so even if they determine that it is more advantageous in the exercise of their governmental func-

tions; and (2) the taxation of the interest on their bonds in any event will impose on them a heavy burden of cost and of potential regulation by the United States of their exercise of their governmental activities.

While the order of this Court dated June 13, 1983 sets down argument at this time solely on the jurisdictional question presented by South Carolina's motion for leave to file its complaint, it is deemed appropriate to seek leave to file the annexed brief on the merits because the defendant in his Motion for Leave to File a Supplemental Memorandum asserted the Court's power "to reject plaintiff's claim on the merits without granting leave to file the Complaint" and "urge[d] that result if the Court concludes that no jurisdictional barrier stands in the way." (p. 2, fn.)

Respectfully submitted,

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TABLE OF CONTENTS

PAGE

Motion for Leave to File Brief *Amicus Curiae* i

Table of Authorities iv

Statement 1

Facts 2

Summary of Argument 8

ARGUMENT—

POINT I—

The scope of the immunity of state and local government bond interest from federal taxation 9

POINT II—

This Court has decided and never retreated from the rule that the National Government lacks the constitutional power to tax the interest on the bonds of the States and their agencies. The reason for the rule applies with full force today 11

POINT III—

The history of the Sixteenth Amendment shows an intention to deny the National Government power to tax state and local government bond interest 17

TABLE OF AUTHORITIES

Cases: PAGE

American Bank & T. Co. v. *Dallas County*, 51 U.S.L.W. 5181, 5188 (U.S. July 5, 1983) 5

Ashton v. *Cameron County W.I. District*, 298 U.S. 513 (1936) 6

Bank of Commerce v. *New York City*, 2 Black 620 (1863) 5

Brushaber v. *Union Pacific R. Co.*, 240 U.S. 1 (1916) 19

Collector v. *Day*, 11 Wall. 113 (1871) 11

Faitoute Iron and Steel Company v. *City of Asbury Park*, 316 U.S. 502 (1942) 6

Farmers & M. Savings Bank v. *Minnesota*, 232 U.S. 516 (1914) 5

Gillespie v. *Oklahoma*, 257 U.S. 501 (1922) 11

Graves v. *New York ex rel. O'Keefe*, 306 U.S. 466 (1939) 11

Greiner v. *Lewellyn*, 258 U.S. 384 (1922) 12

Hale v. *Iowa State Board*, 302 U.S. 95 (1937) 12, 17

Helvering v. *Gerhardt*, 304 U.S. 405 (1938) 9, 11

Helvering v. *Mountain Producers Corp.*, 303 U.S. 376 (1938) 11

James v. *Dravo Contracting Co.*, 302 U.S. 134 (1937) 7, 11

Metcalf & Eddy v. *Mitchell*, 269 U.S. 514 (1926) 11, 13

Missouri v. *Gehner*, 281 U.S. 313 (1930) 5

National League of Cities v. *Usery*, 426 U.S. 833 (1976) 13, 13n

National Life Insurance Company v. *United States*, 277 U.S. 508 (1928) 5

PAGE

New York ex rel. Cohn v. *Graves*, 300 U.S. 308 (1937).... 12

New York v. *United States*, 326 U.S. 572 (1946) 9, 12, 13

Peck & Company v. *Lowe*, 247 U.S. 165 (1918) 19

Plummer v. *Coler*, 178 U.S. 115 (1900) 12

Pollock v. *Farmer's Loan and Trust Company*, 157 U.S. 429; 158 U.S. 601 (1895) .....*passim*

South Carolina v. *United States*, 199 U.S. 437 (1905) 2

Stanton v. *Baltic Mining Company*, 240 U.S. 103 (1916) 19

United States v. *Bekins*, 304 U.S. 27 (1938) 6

Willcutts v. *Bunn*, 282 U.S. 216 (1931) 20

Shamberg v. *Commissioner of Internal Revenue*, 3 T.C. 131 (1944) *aff'd*, 144 F.2d 998 (2d Cir. 1944) *cert. den.* 323 U.S. 792 (1945) 5, 6n

Constitutional Provisions:

Article I §8 Cl. 1 1

Tenth Amendment 14, 15

Sixteenth Amendment 9, 17, 20

Statutes:

Internal Revenue Code of 1954 1

Municipal Bankruptcy Act of 1976, 11 U.S.C.A. 101 *et seq.* 6

Revenue Act of 1913 §II, B, 38 Stat. 168 ..... 2n

Revised Statutes 3701 5

Tax Equity and Fiscal Responsibility Act of 1982 15

PAGE

Treasury Regulations:

IRC §103 ..... 2, 14
IRC §103A 7, 9, 16
IRC §103(b) 8, 9
IRC §103(b)(2) 10, 14, 14n
IRC §103(b)(4)(D) 14
IRC §103(b)(3) 14n
IRC §103(b)(4) 16
IRC §103(b)(13) 15n
IRC §103(c) 8, 9, 16
IRC §103(j) ..... *passim*
IRC §103(k) 14, 15, 16
IRC §103(k)(1) 15
IRC §103(k)(2)(B) 15
IRC §501(c)(3) 14n
26 CFR 2n
26 CFR §1.103(b)(5)(iii) 16n
26 CFR §1.103(7)(b)(2) 14n
26 CFR §1.103(7)(b)(3)(iii) 14n
26 CFR §1.103-13(b)(5)(iii) 16n
26 CFR §1.103-13(c)(1)(iii) 16n
26 CFR §1.103-14(e) 16n
31 CFR Part 344 ..... 16n

PAGE

Miscellaneous:

Hearings on H.R. 7378 before the Senate Finance Committee, 77 Cong. 2d Sess. (1942) 7n

Report of the Senate Finance Committee, S.Rep. No. 97-494, 97 Cong. 2d Sess. 242 (1982) 2n

Report of the Special Senate Committee on Taxation of Governmental Securities for Salaries (S.R. 303, 75 Cong. 3d Sess.) S.Rep. No. 2140, 76 Cong. 3d Sess. (1940) 12

44 Cong. Rec. 1548, 1568-1569, 3344, 3377, 3900 (1909).... 18

45 Cong. Rec. 1694, 2245, 2247 (1910) 19

56 Cong. Rec. 10631 (1918) 19

86 Cong. Rec. 18199-18203, 18458-18472, 18550-18560, 18562-18563, 18565, 18577-18583, 18593-18621 (1940).... 12n

Bond Buyer April 19, 1966 ..... 10n

Bond Buyer July 8, 1963 ..... 9n

Private Letter Ruling 83-1905 dated February 7, 1983 14

Public Papers of Governor Hughes 18n

Solomon Brothers, "1983 Prospects for Financial Markets" 3n, 5n

The New York Times, September 26, 1983 ..... 16n

New York World, March 1, 1910 19

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STATE OF SOUTH CAROLINA,

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Defendant.

Statement

The bond registration requirement here in issue is an example of how the power to tax involves the power to destroy State and municipal options which are perfectly lawful. The provision is in the Internal Revenue Code of 1954 ("IRC"), §103(j). It was enacted under the revenue-raising power of Congress (Const. Art. I, §8 cl. 1). Yet nobody can believe that it was expected that any revenues would be derived from it. The purpose and effect was and is to compel the issuance of bonds in registered form whether or not any State or City finds it advantageous to use bearer instruments.

The rule of *Pollock* v. *Farmers' Loan & Trust Co.*, 157 U.S. 429, 585, 602, 652, 158 U.S. 601, 630, 685, 693 (1895), is that state and local government bond interest is constitutionally immune from federal income taxation. Plaintiff State has unequivocally invoked the rule in its brief supporting its Motion for Leave to File Complaint (pp. 44, 50, 60-63), and the defendant has inferentially questioned the rule in a footnote in his Brief in Opposition (p. 7).

The sole inquiry should be whether the tax penalty on the issuance of state and municipal bonds is within any recognized exception to the *Pollock* rule.

It is a truism that tax-exempt borrowing is less expensive borrowing. The corollary is that the loss of tax ex-

emption means higher costs, which, at a minimum, mean either greater state and municipal dependence on federal largesse or less public services, higher local taxes and charges, and even the inability to borrow at all.

But on a higher plane, the immunity rule protects the balance between the States and the National Government in our delicately balanced federal system, a balance to which this Court has committed itself. *South Carolina* v. *United States*, 199 U.S. 437, 448 (1905). Whether or not the power to tax involves the power to destroy, it certainly involves the power to inhibit and the power to control.

What began in 1913 as a three-line exemption[1] has grown in IRC §103 to 16 pages of qualifications and exceptions[2] and to 82 pages of sometimes baffling Treasury Regulations thereunder.[3] We shall give examples of the way state government activity has thus been controlled, some of questionable validity, but nevertheless complied with in order to issue the bonds at all.

Our concern is that a statutory exemption alone is an insufficient barrier to control-by-taxation and that any denigration of the *Pollock* doctrine in this case would encourage Congressional and Treasury intrusions at the expense of state and local self-government.

Facts

The only fact in dispute in this case is the utility of IRC §103(j). The Senate Finance Committee said of the provision, "registration will reduce the ability of noncompliant taxpayers" to evade taxes, and "may reduce the volume of readily negotiable substitutes for cash available to persons engaged in illegal activities."[4] Tax-evaders and criminals are not so easily discouraged.

IRC §103(j) applies only to bonds issued on or after July 1, 1983. This leaves over $450 billion of outstanding bearer bonds with varying maturities extending in many

[1] Revenue Act of 1913, §II, B. 38 Stat. 168.
[2] In the Prentice Hall compilation, June 1, 1983 Edition.
[3] 26 CFR, pp. 499-581.
[4] S. Rep. No. 67—494, 97th Cong. 2d Sess. 242 (1982).

cases for 30 years or more.[5] We cannot speculate on what the needs of the underworld or tax evaders may be for bearer bonds, but it is obvious that for at least a generation they can be fully met by hundreds of billions of dollars of outstanding bonds, to which IRC §103(j) does not apply.

Thus, on the "plus" side we have a non-existent cure in our time. On the "minus" side, the consequences to the States and cities occur immediately. They have no choice but to issue bonds in registered form. The market will not accept bearer bonds at tax-exempt yields so long as IRC §103(j) is in force.

If certificates are used, as in the case of corporate, foreign and most federal bonds, then great and continuing cost burdens are thrust on the issuer. (Affidavit in support of the motion (Para 8), and affidavits in the appendix to the *amicus curiae* brief of Texas and 23 other States.) But it is obvious and within the Court's judicial knowledge. Many more certificates will have to be printed initially so as to have an ample supply to issue to subsequent transferees over the life of the bonds. Every transfer involves a cost in processing it, recording it on the registration records, and executing and mailing the new certificate. All these costs of transfer are avoided in the traditional bearer bond system.

As for interest payments on coupon bonds, the issuer makes a single timely deposit with its paying agent of all interest due on all the bonds, and on the due date each bondholder can deposit his coupons with his own bank for collection, just as in the case of a check to his order. The issuer's costs of payment are modest. But in the case of registered bonds, there is the added cost of mailing and processing each interest payment check to each bondholder.

If a non-certificated, book entry, form of registration is used, the transfer costs can be reduced, but the additional interest payment costs are the same.

Nor can the state or local government issuer escape those added costs by passing them on to its bondholders.

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[5] Solomon Brothers, "1983 Prospects for Financial Markets", p. 26.

Any attempt to do that will at once be reflected in a correspondingly lower price for its bonds on original issue.

Nothing appears in the legislative history to quantify either these immediate and certain cost burdens on state and local governments, nor the conjectural enhancement of federal revenues. Any remote federal gain from limiting improper uses of bearer bonds, can be but a tiny fraction of the certain and immediate cost burden thrust on states and cities.

Congress did not consider any alternatives to achieve its stated purpose. We submit that identification of bondholders can be achieved without registration and even for outstanding as well as future issues.

One more effective system could be based on a requirement that the issuer's paying agent retain records of the persons to whom interest and principal payments are made and reveal them to the Internal Revenue Service on proper request. Add to this a requirement that any such person shall disclose, on request, the identity of his vendor, and that any such vendor, in turn, shall disclose his vendor, etc., and it becomes possible to construct a chain of ownership as informative as registration (which itself is susceptible to manipulation by the use of "dummies").

The fact is that the holder of bearer bonds with bearer coupons reveals his identity when he collects the interest. He encloses the coupons in an envelope on the back of which he identifies himself and gives the number of his bank account. He then deposits this envelope with his own bank, which transmits the coupons to the issuer's paying agent for collection, and credits the bondholder's bank account.

The same process occurs at the maturity of the bond for the principal amount due.

There is no constitutional objection to requiring the paying agent to reveal the ownership thus disclosed.

The Constitution should not be interpreted to sanction punitive taxation of state policy decisions when it is unnecessary for the fulfillment of the federal purpose.

The impact of a tax on municipal bond interest rates was the subject of a trial in *Shamberg* v. *Commissioner*, 3 T.C. 131 (1944) *aff'd* 144 F.2d 998 (2d Cir. 1944), *cert. den.* 323 U.S. 792 (1945). The Commissioner's press release described the case as a "test action intended ultimately to prove in the courts that the Federal Government has the right under the Constitution to tax the income from state and municipal securities." [6]

Both the Treasury's and the taxpayer's testimony agreed that an interest rate increase would ensue. The taxpayer's witnesses established differentials of about 44% of the then yields on tax exempt bonds. Treasury witnesses' conceded about 30%. In constitutional terms this difference was irrelevant; the conceded burden was substantial.

The Court may well take judicial notice of that fact. It appears to have done so in the case of proposed state taxes on federal bonds in *Bank of Commerce* v. *New York City*, 2 Black 620, 631 (1863); *Farmers & M. Savings Bank* v. *Minnesota*, 232 U.S. 516, 527 (1914); *Missouri* v. *Gehner*, 281 U.S. 313, 321 (1930). The same judgment is implied in this year's decision in *American Bank & T. Co.* v. *Dallas County*, 51 U.S.L.W. 5181, 5188, (U.S. July 5, 1983) Col. 2 last Para. in which a Texas tax on national bank shares was upset under R.S. 3701 because it was reasonable for Congress to conclude that the tax unduly burdens federal obligations "by threatening to diminish their value."

In *National Life Ins. Co.* v. *United States*, 277 U.S. 508, 528 (1928), Justices Brandeis, Holmes and Stone, dissenting, said, "It is true that the tax-exempt privilege is a feature always reflected in the market price of bonds. The investor pays for it." The majority did not disagree.

If the differential on outstanding bonds is about 30% of the exempt rate, then on outstanding debt of some $500 billion[7], even if the average interest rate is only 6% or some $30 billion, the States and local governments are

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[6] Brief (in this Court) in Opposition to Petition for a Writ of Certiorari (October Term, 1944, No. 707), p. 13. The case was, however, ultimately decided on statutory ground.

[7] Solomon Brothers, op. cit. *supra* fn. 6.

being spared some $9 billion a year by reason of the exemption of their bond interest.[8]

Higher state and local borrowing costs, if not offset by federal grants, only can be met by higher taxes and charges or by reduced services or by curtailed borrowing, voluntarily or involuntarily.

Sometimes, however, taxes cannot be increased. "The notion that a city has unlimited taxing power is, of course, an illusion." *Faitoute Iron & Steel Co.* v. *City of Asbury Park,* 316 U.S. 502, 509 (1942).

The fragility of local finances under some circumstances is stressed by the enactment by Congress of three successive Municipal Bankruptcy Acts. See *Ashton* v. *Cameron County W.I. Dist.,* 298 U.S. 513 (1936); *United States* v. *Bekins,* 304 U.S. 27 (1938); 11 U.S.C.A. 101 et seq. (1976).

The 1976 Municipal Bankruptcy Act was enacted in the wake of New York City's financial travail.

The consequences of default are not limited to bondholders. The issuer's short term credit disappears when it is most needed. Salaries and wages are impacted and positions pruned; employee morale is shattered; recruitment of able replacements is impaired. Maintenance of infrastructure is deferred and highway bridges collapse; social services are curtailed; classroom size is increased; garbage collection is reduced; police and fire protection is cut back. All these threats to public health and safety would be either caused or hastened and prolonged if distressed municipal borrowers were compelled to shoulder, in addition, the increased cost of taxable borrowings.

The consequence of the added interest cost would not be terminated once the state or municipal borrower succeeded in issuing its bonds at the higher interest rate. Having assumed the added obligation, it would have weakened its resistance to any subsequent jar to its economy.

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[8] On the trial in *Shamberg, supra,* the two sides did not agree on the size of any corresponding loss. Taxpayers witnesses testified that it would be less than the issuers' gain. Treasury witnesses testified to the contrary.

The Court recognized this in *James* v. *Dravo Contracting* Co., 302 U.S. 134, 152-153 (1937), when it said

> "the doctrine of immunity with respect to government bonds • • • would directly affect the government's obligation as a continuing security. Vital considerations are there involved respecting the permanent relations of the government to investors in its securities and its ability to maintain its credit."

Dravo cited *Pollock* for the conclusion that a tax on bond interest "would operate on the power to borrow before it is exercised". This prior effect occurs particularly when the increase in interest cost resulting from taxability would make it impossible for local governments with marginal credit to borrow at all by pushing costs beyond their capacity to meet. It would also apply to revenue bonds to finance projects payable out of charges on the users. Additional debt service caused by taxation in these cases could often make impossible the projected coverage of debt service by future revenues, and thus the tax would abort the project.

In our time it is not uncommon for bills in Congress imposing a tax on some categories of municipal bonds to be introduced with effective dates at or before the time of introduction. A recent example was the introduction in 1979 by the House Ways and Means Committee Chairman of H.R. 3712 to tax the interest on certain municipal bonds to finance mortgages to homeowners (Cf. IRC §103A).

Bills of this type operate on "the power to borrow before it is exercised" even before there is any Congressional enactment. The market must take into consideration the possibility that the bill will be enacted.

The same principle would operate if this Court in this case were to question the *Pollock* rule. Investors remember that in 1942 the Secretary of the Treasury proposed and the Congress debated repeal of the exemption of the interest on state and local government bonds already outstanding[9] as well as future issues. If this Court were to

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[9] Hearings on H.R. 7378 before the Senate Finance Committee, 77th Cong., 2d Sess. pp. 3-7.

question the constitutional inhibition against taxing the interest, the fear of future attempts would push up interest rates, no matter what assurances were given by the President and Congressional leaders that they contemplated no general taxation of the interest.

Summary of Argument

Point I argues that no exception to the established bond interest immunity rule permits Congress to require that bonds issued to finance governmental activities must be registered or forfeit that immunity.

We do not claim that the bond immunity rule is absolute. In other applications of the basic doctrine of tax immunity the Court has limited it to situations where it would not withdraw traditional sources of federal taxation. This is the justification for taxing certain bonds defined as "industrial development bonds" (IRC §103(b)) and "arbitrage bonds" (IRC §103(c)).

However, bearer bonds do not withdraw traditional sources of federal taxation. They do not add one cent to the volume of public debt which has traditionally been beyond the power of Congress to tax. Unlike the other categories, it is not their use by the States and cities which is supposed to impact the federal revenue base, but their misuse by a few holders in ways already unlawful.

Point II traces the history in this Court of the rule, originating in *Pollock*, that it is unconstitutional for the Federal Government to tax state and municipal bond interest. The rule has never been questioned here. Whenever the Court declined to extend basic state tax immunity to some other activity, it pointedly preserved the bond interest immunity. Cases cited by the defendant's footnote 8 in its Brief in Opposition (p. 7) to imply the contrary turn out to be *reaffirmations* of the rule. The Point then deals with the philosophic basis for the rule by demonstrating the enormous degree of control over state governmental operations which would flow from the power to tax and the concomitant power to classify by exemption and to regulate by conditions.

Point III adds the history of the Sixteenth Amendment. Ratification was achieved only after the Amendment's sponsors, in Congress and other forums, publicly assured the States that the Amendment would *not* authorize such taxation of their bond interest. It would be a breach of faith with the States, which relied on such assurances to complete ratification, for Congress to assert or this Court to find authority anywhere in the Constitution for such a tax.

ARGUMENT

POINT I

The scope of the immunity of state and local government bond interest from federal taxation.

We do not contend that the immunity of state bond interest is absolute. For the basic reciprocal tax-immunity rule to apply to any state activity, it must satisfy the test announced in *Helvering* v. *Gerhardt*, 304 U.S. 405, 419 (1938), as refined by the prevailing Justices in *New York* v. *United States*, 326 U.S. 572, 586 (1946).

New York v. *United States* was the last case in this Court to propound a test for the proper application of state tax immunity. The only exception it allowed was where the claimed immunity might withdraw traditional sources from the federal taxing power.

While, as we shall show in Point II, as a general rule the borrowing power satisfies this test, it can be used in ways which do not satisfy it.

Congress has identified three such situations in taxing certain "industrial development bonds" and all "arbitrage bonds" (IRC §103(b) and (c)), and in limiting the exemption of family mortgage subsidy bonds" (IRC §103A).

Each of these provisions was preceded by threatened expansion of tax-exempt bonds in novel areas. Revenue bonds to finance multi-million dollar loans to high-credit private industries with no municipal financial or functional involvement were spreading.[10] They were mere con-

[10] Bond Buyer, July 8, 1963.

duits of the tax exemption to the private users. They could, if not checked, displace taxable corporate bonds. We may question the breadth of the definition of "industrial development bonds" in IRC §103(b)(2) and the wisdom and even validity of some of the exceptions and conditions, but it remains true that Congress was seeking in 1968 to deal with a threatened erosion of a traditional federal tax source.

The same is true as to "arbitrage bonds". The trigger was a proposal by a state university to issue $300 million of bonds, devote $40 million needed for a new project and invest the remaining $260 million in Federal Government bonds at sufficiently high yields so that the investment earnings would cover all debt service requirements on the whole $300 million issue.[11] Such programs could multiply the volume of tax-exempt bonds eight-fold.

However, these exceptions to stem massive withdrawals of federal tax sources cannot, as defendant implies (Brief in Opp. p. 7, fn. 8), justify taxation of the interest on unregistered bonds which involve no such withdrawal.

Restrictions on "industrial development bonds" and "arbitrage bonds" were justified on the basis of what the States and cities themselves might do that would erode a traditional federal tax base. But the only misuse of bearer bonds is ascribed not to the States and cities but to others acting unlawfully.[12]

The Finance Committee's justification for IRC §103(j) does not match any known exception to the basic immunity rule.

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[11] Bond Buyer, April 19, 1966.
[12] See footnote 5, *supra*.

POINT II

This Court has decided and never retreated from the rule that the National Government lacks the constitutional power to tax the interest on the bonds of the States and their agencies. The reason for the rule applies with full force today.

The basic constitutional immunity of municipal bond interest was decided by this Court unanimously in two decisions in *Pollock* v. *Farmers' Loan & Trust Co.*, 157 U.S. 429; 158 U.S. 601, 630 (1895).

Never has this decision been questioned by this Court. Indeed, whenever the Court withdrew a prior application of the basic immunity or declined to extend it to a new example, it carefully refrained from questioning the bond interest immunity rule of the *Pollock* case, and said so.

Thus, *Collector* v. *Day*, 11 Wall. 113 (1871) applied the immunity rule to state and local governmental salaries and that application was denied in *Helvering* v. *Gerhardt*, 304 U.S. 405 (1938). Defendant asks the Court to compare *Gerhardt* with *Pollock* (Brief in Opp., p. 7, fn. 8). And so do we. *Gerhardt*, in effect, reaffirmed *Pollock* by citing it as a proper case for immunity. 304 U.S. at 417.

Graves v. *New York ex rel. O'Keefe*, 306 U.S. 466 (1939), also cited by defendant merely made the *Gerhardt* rule reciprocal, allowing the States to tax federal salaries.

In the area of taxation of income derived by a lessee from lands leased to him by a government, immunity was allowed first in *Gillespie* v. *Oklahoma*, 257 U.S. 501 (1922) and was withdrawn in *Helvering* v. *Mountain Producers Corp.*, 303 U.S. 376 (1938), which the defendant also asks the Court to compare with *Pollock*, and so do we.

Bond immunity was there expressly distinguished and *Pollock* cited, 303 U.S. at 387, as "bearing directly upon the exercise of the borrowing power of the Government."

In permitting taxation of governmental contractors, the Court made the same distinction in favor of *Pollock*, in *Metcalf & Eddy* v. *Mitchell*, 269 U.S. 514, 522 (1926). And in *James* v. *Dravo Contracting Co.*, 302 U.S. 134,

152-153 (1937), the Court did the same thing, saying of the *Pollock* doctrine:

> "Vital considerations are there involved respecting the permanent relations of the government to investors in its securities and its ability to maintain its credit,—considerations which are not found in connection with contracts made from time to time for the services of independent contractors."

There was, thus, in the late 1930's a retreat in some areas from application of the reciprocal constitutional immunity, doctrine—but *no* retreat from the acceptance of *Pollock* and its reasoning. See also *Hale* v. *Iowa State Board,* 302 U.S. 95, 107 (1937); *New York ex rel. Cohn* v. *Graves,* 300 U.S. 308, 315 (1937); *Plummer* v. *Coler,* 178 U.S. 115, 117 (1900); *Greiner* v. *Lewellyn,* 258 U.S. 384, 387 (1922).

In 1938 the Senate established a Special Committee on Taxation of Governmental Securities and Salaries (S.R. 303, 75th Cong., 3d Sess.). It is Part 1 of the Report of that Committee that the defendant cites (Brief in Opp. p. 7) for his statement that "the authorities seriously question the premise underlying its (plaintiff's) complaint, viz. that the Constitution requires federal tax exemption on the interest on state obligations." (S. Rep. No. 2140).

However, of the six Senators on the Committee, only three joined in that aspect of the report (Part 1, p. 16) and its recommendation was rejected by the Senate after a full debate on its constitutionality.[13]

Part 2 of the Report was an elaborate defense of the constitutional bond immunity rule. It closely followed a brief submitted to the Committee by the attorneys general of 39 states[14] and by your present *amicus curiae,* the National Institute of Municipal Law officers.

The most serious threat to the States' constitutional immunity from federal taxation occurred in *New York* v. *United States,* 326 U.S. 572 (1946). The Court on October 8, 1945, requested counsel on reargument to consider

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[13] 86 Cong. Rec. 18199-18203, 18458-18472, 18550-18560, 18562-18563, 18565, 18577-18583, 18593-18621.

[14] Including, incidentally, Earl Warren of California.

specific questions, including one whether a non-discriminatory Federal tax could constitutionally apply to "any state property or activity or the income derived by the state from them."

The Court's questions provoked *amicus curiae* briefs by the attorneys general of 47 States and by your present *amicus*, National Institute of Municipal Law Officers.

The judgment was that New York was required to pay the excise tax. But only Justices Frankfurter and Rutledge would have permitted "nondiscriminatory" taxation of state property, activities, and incomes. Six Justices disagreed.

Four Justices concurred in the judgment but rejected the Frankfurter approach.[15] Their test of a proper exception to state immunity was whether the States were enlarging their activities in ways, which, if immune, would withdraw traditional sources of federal revenue.

Justices Douglas and Black (326 U.S. at 590), as the Court said in *National League of Cities* v. *Usery*, 426 U.S. 833, 843, fn. 13 (1976), "advocated a position even more protective of state sovereignty." They made a point of referring to the issuance of securities as protected by the immunity rule. 326 U.S. at 591, 593.

National League of Cities v. *Usery*, 426 U.S. 833, 843 (1976), while not a tax case, was based in part on the four-Justice opinion in *New York* v. *United States* and on the statement in the tax case of *Metcalf & Eddy* v. *Mitchell*, 269 U.S. 514, 523 (1926) that "neither government may destroy the other nor curtail in any substantial manner the exercise of its powers."

On its face the registration requirement of IRC §103(j) offends this updated test; it would curtail in substantial manner the exercise of the State's power to determine the optimal form of its bonds.

In arguing on the Court's questions in *New York* v. *United States*, the state attorneys general, as *amici*, argued

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[15] 326 U.S. at 586. The unusual sequence of the opinions in *New York* v. *United States* was noted in *National League of Cities* v. *Usery*, 426 U.S. 833, 843, fn. 13 (1976).

from hypothetical examples that the power to tax state activities would necessarily bring on federal control of the States by exemptions, conditions and qualifications. (Br. p. 20). Our examples need no longer be hypothetical. Control by taxation of municipal bond interest exists in and under portions of IRC §103, itself.

In February, 1983, the IRS ruled that bonds of the City of Atlanta issued to improve runways at its public airport and satisfying all Georgia state law requirements for valid issuance by Atlanta will be taxable unless, in addition, a second municipality in which the runway is located also approved the bonds under IRC §103(k).[16]

The distribution of a State's powers as between its political subdivisions is clearly reserved exclusively to the States by the Tenth Amendment. Yet Congress asserts it under the taxing power.

The veto thus given by Congress to some municipalities over certain authorized activities of other municipalities arises by reason of the definition in IRC §103(b)(2) of "industrial development bonds" to which IRC §103(k) applies. The definition includes not only bonds for private industrial development but also bonds to finance any public facility for public purposes if the facility is to have non-exempt users[17] to an extent exceeding 25% and if the bonds are to be paid to an extent exceeding 25% from payments by such users.[18] Congress thus arbitrarily tagged as "industrial development bonds", bonds to finance public airports, public piers, public parking facilities, local public water works, and any other public facility failing the two 25% tests.

Because airports were listed among the "exempt activities" in §103(b)(4)(D), the original tax did not apply to

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[16] Private Letter Ruling 83-1905 dated February 7, 1983.

[17] Non-exempt users include the United States, foreign governments and private persons not listed as exempt under IRC §501 (c)(3). See IRC §103 (b)(3); 26 CFR §1.103(7)(b)(2).

[18] IRC §103 (b)(2) uses the term "major portion" to describe the proscribed quantity of private use or payments. Treasury regulations have quantified "major portion" as anything over 25% 26 CFR §1.103(7)(b)(3)(iii).

airport bonds.[19] But the Tax Equity and Fiscal Responsibility Act of 1982 enacted not only IRC §103(j) but also IRC §103(k) which requires "public approval" in a specified way for *all* "industrial development bonds", including public airport bonds, as well as any other public facility bonds caught up in the definition. Such "public approval" is required not only by the public issuer but by any other political subdivision in which the financed facility is located. (IRC §103(k)(1))

Atlanta's public airport, like those of many other cities,[20] is located outside its municipal boundaries. Having determined that over 25% of the use of a runway improvement to be financed with new Atlanta bonds would be by two airlines, the Treasury ruled in February, 1983 that the bonds would be "industrial development bonds" and would be taxable unless the other municipality approved, and this although Georgia state law gives no such veto to the second municipality.

Congress, in other words, having asserted the power to tax a class of bonds has used it to strip a legislative power from one subdivision of a State and bestow it on another.

Furthermore in IRC §103(k)(2)(B) Congress has prescribed the kind of "public approval" without which such public facility bonds are to be taxed. If the bonds are within the expansive "industrial development bond" definition then they are taxed unless they are approved by an "elected representative" or by "voter referendum". And this is so even if the state constitution or statutes provide that the bonds may be issued without such approvals.

Should not the mechanism for approving state or local government bond issues be exclusively a state function under the Tenth Amendment?

If the answer is that Congress has not required approval of bonds in a way contrary to state law but merely denied tax-exemption to bonds not meeting federal requirements,

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[19] Except, under a provision which is now IRC §103(b)(13), for any period during which the bonds may be held by a "substantial user" of the financed facility.

[20] E.g. San Francisco, Chicago, Cincinnati.

then that answer makes our point. The power to tax is indeed the power to control and regulate the most detailed internal affairs of the States. It truly is the power to destroy state sovereignty.

Under Treasury regulations now in force under IRC §103(c), exemption is forfeited for some refunding bonds of state and local governments *unless the proceeds are loaned to the United States.*[21] What is more, the formula for establishing the interest rate to be paid by the United States translates into a rate below the going market rate payable at the time by the United States to other investors for obligations of the same maturity.[22]

Can anyone doubt that if Congress and the Treasury ever achieved the constitutional power to tax any and all state and local government bonds, they would use it to displace state policy across the board? We could have federal lists of the only permitted purposes for all borrowing as we now have for "industrial development bonds" under IRC §103(b)(4). We could have federal requirements for referenda, multiple municipal approval, and other details of the approval process at the local level, as we now have in IRC §103(k). We could have dollar volume limits on each State, as we now have for "mortgage subsidy bonds" under IRC §103A.

Without the immunity of state and municipal borrowing, the National Government could displace the policies of the States in the governance of local affairs; the balance be-

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[21] This is the combined effect of 26 CFR 1.103-13(b)(5)(iii), 1.103-13(c)(1)(iii) and 1.103-14(e).

[22] The rate must not exceed the yield on the state or local government bond issue except by an infinitesimal amount (26 CFR 1.103(b)(5)(iii)). *Normal* federal bond yields are substantially higher (because they are taxable) than yields on high quality municipal bonds of comparable maturity. See chart, New York Times, September 26, 1983, p. D10.

The Treasury has established a special issue of United States obligations "available" to the States and local governments, and to no one else, to permit them to invest the affected bond proceeds at a low enough rate to permit the escape from unpermitted "arbitrage" (31 CFR Part 344). The volume of such forced loans now outstanding is many billions of dollars.

tween the National Government and the States would be gone.

POINT III

The history of the Sixteenth Amendment shows an intention to deny the National Government power to tax state and local government bond interest.

In a challenge to the 1894 income tax act the first decision in *Pollock* v. *Farmers' Loan & Trust Company,* 157 U.S. 429 (1895), distinguished four kinds of income covered by the act: (1) salaries, professional income and business profits; (2) real estate rentals and profits; (3) income and profits from private personal property, including stock dividends and bond and note interest; and (4) interest from state and municipal bonds. The Court held unanimously that an income tax on income from the source of salaries, professional income and business profit was an indirect tax and within Congress' power without apportionment. 157 U.S. at 578. As to real estate, the Court held 7-2 that a tax on income from that source was a direct tax and that the 1894 act was unconstitutional with regard to it for lack of apportionment. As to the tax on income from the source of personal property, the Court was evenly divided as to whether it was direct so as to require apportionment. As to municipal bond interest, *all* of the Justices agreed that there was a total lack of power, not curable by apportionment, 157 U.S. at 585, 601, 652, 653.

The even division on the personal property question required, occasioned a rehearing and the second *Pollock* decision. 158 U.S. 601 (1895). The result was 5-4 against the constitutionality of an unapportioned income tax on income from the source of personal property as well as real estate (158 U.S. at 637), but a unanimous reaffirmation that income from state and municipal bond interest was totally immune, whether or not the tax was apportioned. See *Hale* v. *State Board,* 302 U.S. 95, 107 (1937). Finally, the entire act was struck down.

On April 27, 1909, Senator Brown introduced a resolution to amend the Constitution to provide "The Congress

shall have the power to lay and collect taxes on income and inheritances." (44 Cong. Rec. 1548). This formulation was criticized because Congress already had that power. Senator Raynor said: "unless you change the clause of the Constitution which provides for apportionment, the joint resolution will not repeal that clause." (44 Cong. Rec. 1568-1569).

On June 16, 1909, President Taft recommended that the Congress "shall propose an amendment to the Constitution conferring the power to levy an income tax upon the national government without apportionment among the states in proportion to population." (44 Cong. Rec. 3344).

Senator Brown responded the next day with the introduction of another joint resolution (44 Cong. Rec. 3377).

> "The Congress shall have power to lay and collect direct taxes on income without apportionment among the several states according to population."

On June 28, 1909, the Senate Finance Committee brought in a joint resolution in the language of the present Sixteenth Amendment. The word "direct" was removed from the Brown formulation and the words, "from whatever source derived," were substituted, with no explanation of the change. (44 Cong. Rec. 3900). It was, however, a more precise formulation because the *Pollock* apportionment requirement, which was to be overcome, related to a distinction between the various sources of income.

No suggestion was ever made in Congress that the proposed Amendment had anything to do with taxation of state and local government bond interest.

The proposed Amendment then went to the States for ratification and was proceeding at a reasonable pace until Governor Charles E. Hughes' famous message to the New York States Legislature on January 5, 1910.[21] He raised the possibility that "The comprehensive words, 'from whatever source derived', if taken in their natural sense, would include not only incomes from ordinary real or personal

[21] Public papers of Governor Hughes, pp. 71, 73.

property, but also incomes derived from State and municipal securities," a result which he opposed.

The sponsors of the amendment reacted sharply. As Senator Borah, a leading supporter of the Amendment, said on February 10, 1910, the Hughes message could derail the ratification process. He therefore made a lengthy legal argument contesting the Hughes position. (45 Cong. Rec. 1694 et seq.).

On February 23, 1910, Senator Brown, the original introducer of the Amendment Resolution, spoke to the Senate to the same effect. (45 Cong. Rec. 2245, 2247).

Senator Root of New York wrote to a member of the New York Legislature to counter the deterrent effect of his Governor's message. He said of the Hughes objection:

> "I do not find in the Amendment any such meaning or effect."

The Root letter was widely publicized. *The New York World* said in an editorial on March 1, 1910 (p. 10):

> "Mr. Root proves that the Amendment does not open a way for the taxation of State securities. He shows that the words from whatever source derived are solely designed to meet the situation raised in the decision of 1895 which distinguished between income from personal property and income derived from business or occupation." [24]

This Court held in 1916, when its members were contemporaries familiar with the debates on the subject and included former Governor Hughes himself, that the Amendment added no new subject to the taxing power of Congress, but merely eliminated the apportionment requirement. *Brushaber* v. *Union Pacific R. Co.*, 240 U.S. 1, 11 (1916); *Stanton* v. *Baltic Mining Co.*, 240 U.S. 103, 112 (1916).

Peck & Co. v. *Lowe*, 247 U.S. 165, 172 (1918) the Court reviewed the history of the Hughes message and the Senators' responses and reached the same result.

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[24] In 1918, Rep. Thomas, in the House of Representatives, said of the Root letter: "Upon the strength and under the interpretation outlined in this letter, the General Assemblies of the States of New York and New Jersey finally ratified the amendment." (56 Cong. Rec. 10631)

In *Willcutts* v. *Bunn*, 282 U.S. 216, 226 (1931), Chief Justice Hughes discarded his earlier concern saying for a unanimous Court:

> "In the case of the obligations of a state or of its political subdivisions, the subject held to be exempt from Federal taxation is the principal and interest of the obligations. *Pollock* v. *Farmers' Loan & Trust Co.*, 157 U.S. 429, 584-586 * * *."

Of all the arguments against the immunity of state bond interest, none is more specious than that it was ended by the Sixteenth Amendment. Rather we submit the contrary: reconsideration of the bond interest immunity rule was foreclosed by the ratification of the Amendment in reliance on assurances by its sponsors that the immunity would survive its adoption.

If Congress has the power to tax the interest on unregistered bonds under IRC §103(j) it cannot be because it has the power to tax the interest on all bonds of the States under the Constitution. It is open to the defendant only to argue that unregistered bonds are within some exception to the basic rule of bond immunity under the Constitution—an exception for which we find no basis.

Wherefore, *Amici* respectfully urge that the relief sought by plaintiff be granted.

Respectfully submitted,

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